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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In The Matter of: 1993 Annual Access Tariff Filings	))))))	CC Docket No. 93-193

COMMENTS ON DIRECT CASES

AD HOC TELECOMMUNICATIONS
USERS COMMITTEE

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SUMMARY

The Commission's OPEB Order (i) found that the LECs had not met their burden of demonstrating that implementation of SFAS-106 should be considered an exogenous cost change under the price cap rules, and (ii) established a two-pronged test under which requests for exogenous treatment of GAAP changes such as SFAS-106 would be considered in the future. In its Designation Order setting for investigation the LECs' 1993 Annual Access Tariff Filings, the Commission considered LEC requests for exogenous treatment of TBO amounts and concluded that the tariff filings had not resolved issues relating to the second, or "double counting", prong of the OPEB Order's exogenous treatment test in each of three areas: intertemporal double counting; rate of return used in setting initial rates; and anticipation of SFAS-106 costs in productivity studies. The Designation Order, while detailing the deficiencies found in the LECs tariff filings and supporting documentation -- wherein the LECs in large measure simply reiterated arguments which had been rejected by the Commission in its OPEB Order -- with respect to each of the three double counting areas, afforded the LECs a still further opportunity to meet their burden of proof on the SFAS-106 issue in their Direct Case submissions. However, in their Direct Cases, the LECs once again reiterate their previously proffered and rejected arguments with respect to the double counting issues. Accordingly, it must be concluded that the LECs have

failed to meet their burden of proof under Issue 1, and their requests for exogenous treatment of TBO amounts should be denied.

Several LEC's having prior year sharing adjustments challenge the Commission's proposal to require "add back" of such adjustments as proposed under Issue 2, arguing that the Commission's rules do not expressly provide for application of an add back mechanism to price cap carriers. Not surprisingly, other LECs -- those that made low-end adjustments in their 1992 Annual Access Tariff Filings -- take the opposite approach. They contend the Commission must allow add back of these amounts in their 1993 Annual Access Tariff Filings. In essence, each group of LECs proposes to manipulate the adjustment process to its own best advantage, and both requests should be denied.

The Commission should require add back of prior year sharing adjustments. Notwithstanding the fact that the Commission has initiated a rulemaking under CC Docket No. 93-179 to clarify the application of the add back requirement to price cap carriers, no exception from this requirement was provided for in the Price Caps Order. Furthermore, the Commission has expressly stated that it was intended from the outset that price cap carriers would be subject to the same rate of return reporting requirements as rate of return carriers, and it is apparent that a "backstop" mechanism is equally necessary to prevent price cap carriers from achieving an effective rate of return outside the wider range they are permitted under the Commission's rules as it is to enforce the more restrictive rate of return limits imposed on traditional rate of return carriers.

On the other hand, the Commission should deny LEC requests for add back of low end adjustments, a proposal that has no support in the Commission's rules or history of rate of return regulation. Low end adjustments are fundamentally different from sharing adjustments: whereas sharing is designed to share past excess earnings with rate payers, providing them the equivalent of a refund, low end adjustments are designed to allow carriers that are underearning to raise rates to a level to allow them to earn reasonably in the future so as to continue to attract capital; thus, low end adjustments are not designed to provide refunds or to compensate carriers for past poor performance. Accordingly, while rate of return calculations historically have included add back of revenue reductions resulting from refunds based either on overearnings or disallowances, they have not included add back of revenue increases resulting from rate increases implemented because of prior year underearnings.

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COMMENTS ON DIRECT CASES

The Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee" or "Committee"), pursuant to the Memorandum Opinion And Order Suspending Rates And Designating Issues For Investigation, DA 93-762, released June 23, 1993, in the captioned proceeding (the "Designation Order"), submits these comments in response to the Direct Cases filed in support of the 1993 Annual Access Charge Tariffs.

I. Issue 1: Have The LECs Borne Their Burden Of Demonstrating That Implementing SFAS-106 Results In An Exogenous Cost Change For The TBO Amounts Under The Commission's Price Cap Rules

The Direct Cases essentially reiterate previously advanced and rejected arguments, providing no additional substantive support for LEC requests for exogenous cost treatment of TBO amounts. It must therefore be concluded that the LECs have not met their burden of proof under this issue, despite having been afforded repeated opportunities to do so.

In its initial denial of requests for exogenous cost treatment of post-retirement benefits other than pensions ("OPEBs" -- essentially, retiree health costs) in CC Docket No.

92-101, the Commission established a clear and explicit two-pronged test under which requests for exogenous treatment of GAAP changes such as SFAS-106 would be considered.[1/] Despite a broadly based determination that the sundry data, studies and expert reports which were submitted by the LECs in that proceeding had fallen well short of demonstrating that OPEBs, at least with respect to forward-looking amounts, had met either the "control" or "double counting" tests required for exogenous cost treatment, the Commission to some extent reserved judgment with respect to a limited category of OPEBs, known as the Transitional Benefit Obligation (TBO), which represents a previously unaccrued obligation amount for OPEBs to retirees and active employees existing as of the adoption date of SFAS-106. Concluding that the LECs had failed to demonstrate that amounts claimed as TBO had not already been accounted for in the GNP-PI, and that the second, double counting, prong of the test had accordingly not been met, the Commission nonetheless stated that "[o]ur decision in this case is not intended to foreclose further consideration

1/ Treatment of Local Exchange Carrier Tariffs Implementing SFAS No. 106, Memorandum Opinion and Order, CC Docket No. 92-101, 8 FCC Rcd. 1024 (1993) ("OPEB Order"). The first, or "control" prong of the test, requires the price cap carrier to show that the imposition of the cost occasioned by the GAAP change is not within its control; the second, or "double counting" prong of the test, requires the price cap carrier to show that the cost is not already reflected in the price cap formula and, as a result, is not double counted as a result of being accorded exogenous treatment.

of exogenous treatment of TBO amounts, based upon a better and more complete record".[2/]

Given this generous opportunity to provide a "better and more complete record" and, in effect, to persuade the Commission to reconsider its decision in CC Docket No. 92-101, several LECs requested exogenous treatment of TBO amounts in their 1993 annual access filings, each seeking to meet the standard established in the OPEB Order.[3/] However, the tariff filings and supporting justification again failed to meet the Commission's test. More specifically, the Commission concluded that the annual access tariff filings had not sufficiently addressed three areas of double counting discussed in the OPEB Order: (i) the intertemporal double counting issue; (ii) double counting related to the inclusion of costs in the prescription of the rate of return which determined the initial price cap rates; and (iii) the anticipation of SFAS-106 costs in the studies underlying the productivity factors.[4/]

In view of the foregoing history, coupled with the absence of any meaningful additional support in the Direct Cases for exogenous treatment of TBO amounts (the LECs' third bite at the

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2/ OPEB Order, para. 76.

3/ See, 1993 Annual Access Tariff Filings of Ameritech, Bell Atlantic, BellSouth, GTOC, GTSC, Lincoln, NYNEX, Rochester, Southwestern, and US West.

4/ Designation Order, para. 29. As it had previously in the OPEB Order, the Commission found it unnecessary to reach the issue of control given its conclusion respecting the double counting issue.

apple), the Ad Hoc Committee believes the Commission can resolve this issue in summary fashion; the LECs have failed to meet their burden of proof. Even without reaching the question of control, it is apparent that the LECs have squandered the further opportunity accorded by the Commission to make a "better and more complete record" with respect to the issue of double counting, merely using their Direct Cases to reiterate or restyle their previously rejected arguments.[5/]

For example, the LECs continue to rely in their Direct Cases upon the "Godwins studies" notwithstanding that both the initial Godwins study and the study released by National Economic Research Associates (NERA) were rejected by the Commission in the OPEB Order because they relied on speculative and conflicting assumptions regarding the impact of SFAS-106 on the LECs' pricing decisions. Concern was also expressed with the reliability of the Godwins results in view of the wide variety of possible parameter input value combinations which might be applicable. Therefore, the OPEB Order correctly concluded that the

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5/ It continues to be unnecessary to address the control issue because the LECs have again failed to satisfy the second, double counting, prong of the test. However, the Committee does not concede that LECs do not exercise at least some control over TBO amounts. As noted in its "Petition For Partial Rejection and Investigation" of the 1993 Annual Access Tariff Flings, filed April 27, 1993, pp. 9-10, "such non-pension benefits are not subject to the statutory vesting requirements of the Employee Retirement Income Security Act" and, therefore, may constitute mere "expectations" subject to substantial control of the employer. The employment materials submitted with the Direct Cases would not meet the LECs' heavy burden of proof established in the OPEB Order with respect to the control issue were it to be considered by the Commission.

speculative nature and close dependency of results on the initial assumptions of these studies would lead to conclusions which were speculative.

The supplemental Godwins study released on March 31, 1993, and filed in support of the LEC annual access tariffs includes additional sensitivity analyses, but it too relies upon assumptions that are uncorroborated by either empirical evidence or statistical analysis. Indeed, the shortcomings of the supplemental Godwins study were made clear in the Designation Order: "The record concerning double counting in the GNP-PI has been enhanced by a second Godwins study. However, other potential areas of double counting discussed in the OPEB Order *have not been sufficiently addressed*."[6/]

Below, we address the three "areas of double counting" specified by the Commission in the Designation Order, and demonstrate that the LECs have failed to resolve the concerns expressed by the Commission with respect to any of them. In brief, no new evidence or arguments have been provided. It is therefore clear that the LECs still have not "sufficiently addressed" the issue of double counting; and there is, accordingly, no basis upon which the Commission can find that the LECs have met their burden of proving that their TBO costs are not already reflected in the price caps formula.

6/ Designation Order, para. 29. (emphasis added).

A. Intertemporal Double Counting

As the Commission itself indicated in the Designation Order[7/] "pay-as-you-go" amounts for OPEBs are already built into the LECs' rates, meaning that the GNP-PI portion of the X factor in the PCIs would give the LECs the funds they need to recover TBO costs. To allow exogenous treatment of these costs along with the recovery over time through the GNP-PI portion of the X factor would result in double counting. The Direct Case filings of the various LECs provide no data beyond that filed with the annual tariffs to dispute that finding.

For example, Bell Atlantic's response to the intertemporal counting issue is that exogenous treatment is justified because its TBO amount relates to previously retired employees and represents "an actuarially-determined cost based on a count of actual employees, not an estimate."[8/] However, far more than an accurate count of the number of retired employees is required. As the Commission correctly noted in its OPEB Order: "absent absolute accuracy regarding forecasts of medical trends, discount rates, retirement rates and other demographic assumptions, LECs would have productivity gains or losses by beating, or failing to beat, the assumptions."[9/] The actuarial reports used to calculate Bell Atlantic's OPEB costs fail to provide anything approaching "absolute accuracy" relative to elements such as

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7/ Id. para. 10.

8/ Bell Atlantic Direct Case, pp. 3-4.

9/ Designation Order, para. 10. (emphasis added).

future medical trends or discount rates. The fact is there can be no "absolute accuracy" in forecasting TBO costs associated with previously retired employees. Further, Bell Atlantic does not address at all the inclusion of "pay-as-you-go" amounts in existing LEC rates.

Southwestern Bell admits that "pay as you go" amounts are already included in its prices but states that the present value of SFAS-106 expenses will exceed the present value of pay-as-you-go expenses. Accordingly, Southwestern Bell requests exogenous treatment of only the increment of SFAS-106 costs above pay-as-you-go costs.[10/] Southwestern Bell offers to make specific adjustments to its price caps formula and to future annual filings to prevent "double-counting" or a "windfall."[11/] Setting aside the fact that this kind of proposed "fix" for the double counting problem is in essence an acknowledgment that intertemporal double counting in fact occurs, it was expressly determined in the OPEB Order (and reiterated in the Designation Order, paragraph 10) that a "year-by-year true up mechanism" of the type proposed by Southwestern Bell would be "an undesirable and complex addition to the price cap plan."[12/]

10/ It should also be noted that SWBT's estimate of the difference between present value of SFAS-106 expenses and the present value of "pay-as-you-go" expenses is necessarily generated by forecasts of discount rates that can not be "absolutely accurate".

11/ Southwestern Bell Direct Case, pp. 22-23, 42. GTE proposes a similar annual "true-up" mechanism. GTE Direct Case, p. 19.

12/ OPEB Order, para. 69.

B. <u>Rate of Return Used in Setting Initial Rates</u>

In its Designation Order, the Commission repeated the view expressed initially in its OPEB Order that "there must have been at least some doubt" about whether the LECs would be able to change their rates when SFAS-106 was implemented, and concluded that this additional risk would be reflected in a relatively higher return.[13/] In these circumstances, since the SFAS-106 change would be already reflected in the initial rate of return set under price caps, an allowance of an exogenous cost change for SFAS-106 would result in double counting.

Although the majority of the LECs attempt to address this issue in their Direct Cases, none of the Direct Cases provides evidence sufficient to meet the burden of proof on this issue, or to otherwise demonstrate that double counting would not result from exogenous treatment of SFAS-106 costs. Ameritech, for example, asserting that it "addressed these issues" in its Annual Access Tariff D&J, simply reiterates its previously advanced argument that "investors could not have required a greater rate of return for SFAS-106 costs in September, 1990; because the Commission at that time indicated that it would grant exogenous cost treatment for all mandatory GAAP changes."[14/] However, Ameritech's argument does not address the Commission's conclusion that there must have been "some doubt" on the part of investors

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13/ Designation Order, para. 11.

14/ [redacted]

as to whether LECs would be able to change their rates when SFAS-106 was implemented.[15/] Ameritech's unproven assertion that investors had an expectation that TBO costs would be granted exogenous treatment, even if accepted, does not mean there would still not be "some doubt" in investors' minds that Ameritech would be able to implement rate increases to recover such costs. Indeed, even assuming investors anticipated exogenous treatment of TBO costs, reasonable investors would have harbored significant doubts relative to Ameritech's ability to increase rates, particularly in view of (i) the LECs' repeated public assertions that their markets are increasingly competitive, and (ii) the fact that, as a general matter, competitive firms have not increased prices to compensate for SFAS-106, but have instead written-off earnings.[16/]

15/ OPEB Order, para. 72.

16/ See, Ad Hoc "Petition for Partial Rejection and Investigation" filed April 27, 1993, pp. 6-8. As discussed therein in further detail, while at first glance the combined 1992 earnings of the largest U.S. industrial corporations seem to have been the lowest since the 1950s, after adjustments are made for the one-time hit for retiree health benefits, the industrials' reported earnings were drastically transformed. Although the SFAS-106 charge-offs had no effect on corporate cash flows and barely effected the stock market, without the new rule, reported earnings would have risen to $70.5 billion -- 17.5% better than the comparably adjusted figures for 1991. Fortune, April 19, 1993, at 174-175. Thus, the impact of the SFAS-106 rule on reported profits was large in an accounting sense, but was not reflected in stock price movements. These findings confirm the Commission's conclusion that the LECs' rate of return prescriptions would already include reasonable investor perceptions of the effects of the adoption of SFAS-106.

Bell Atlantic's Direct Case notes that the average price of RBOC stock rose 35% between January 1, 1986 and December 31, 1988, and asserts that there is "no basis to assume that anticipation of the impact of SFAS-106 prior to its implementation caused RBOC stock prices to fall."[17/] However, the question is not whether the impact of SFAS-106 caused RBOC stock prices to fall, but rather whether the impact of SFAS-106 has been accounted for in the prescribed rate of return going into price caps. Indeed, Bell Atlantic's observation with respect to the positive performance of RBOC stock prices supports the available evidence that SFAS-106 implementation was anticipated by investors and, therefore, has had little adverse effect on stock prices.

Similarly, NYNEX's claims that exogenous treatment of TBO costs will occasion no double counting because the Commission did not consider the costs of SFAS-106 during the rate prescription process, and because these costs were unknown at the time, appear to miss the point.[18/] The question is not whether the Commission considered SFAS-106 costs during the rate prescription process. The question is whether the LECs' rate of return prescriptions already included investor perceptions of the effects of the adoption of SFAS-106 by major publicly traded corporations. The available evidence, unrebutted in the Direct Cases, indicates that while the effects of SFAS-106 on reported

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17/ Bell Atlantic Direct Case, p. 4.

18/ NYNEX Direct Case, p. 25.

profits of major U.S. corporations were significant from an accounting standpoint, they had no effect on corporate cash flows and negligible impact on the stock market, a clear indication of investor anticipation of these effects.[19/]

C. Anticipation of SFAS-106 Costs in Productivity Studies

The third and final aspect of the double counting issue concerns whether SFAS-106 amounts were already included in price caps productivity adjustments.[20/] Here again, the Direct Cases provide no new evidence to discount the likelihood that the TBO amounts for which the LECs request exogenous treatment are already included in studies used to derive the productivity factors. For the most part, the Direct Cases simply reiterate the arguments presented in the LECs' annual access tariff filings - arguments that the Commission found did not "sufficiently address" the subject in a manner that met the LECs' burden of proof under this issue.

For example, Ameritech states that current retiree TBO amounts were not included in studies used to determine the productivity factor because VEBA trusts (which are reflected in the studies used to derive the present productivity factor) recognize deferred compensation for active employees and do not affect TBO amounts.[21/] This is the same argument presented in

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19/ See, Ad Hoc Petition For Partial Rejection And Investigation, pp. 5-8.

20/ Designation Order, para. 11.

21/ Ameritech Direct Case, p. 4,

Ameritech's annual tariff filing.[22/] Likewise, GTE claims, once again, that there would be no double counting because exogenous treatment is requested only for incremental costs resulting from SFAS-106, not for total SFAS-106 costs.[23/] Repetition of these previously proffered arguments, found wanting by the Commission in the Designation Order, simply confirm that the LECs have not met the burden of proof required to justify exogenous cost treatment for TBO amounts.

II. Issue 2: How Should Price CAP LECs Reflect Amounts From Prior Year Sharing And Low-End Adjustments In Computing Their Rates Of Return For The Current Year's Sharing And Low-End Adjustments To Price Cap Indices

The Ad Hoc Committee urges the Commission to require LECs to "add back" prior year sharing adjustments. However, the Commission must not permit add back for prior year Lower Formula Adjustments ("LFAs") as certain LECs have proposed in their 1993 annual access tariff filings.[24/] Contrary to arguments advanced in several of the Direct Cases, requiring application of the add back requirement to prior year sharing amounts reflected in the 1993 annual access tariff filings would be fully consistent with the Commission's price cap regulatory regime, as

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22/ Ameritech D&J, p. 13.

23/ Bell Atlantic's Direct Case also relies upon a restatement of its previous arguments relative to this issue.

24/ Not surprisingly, only those carriers that made low-end adjustments in 1992 (NYNEX and SNET) added back amounts in the 1993 annual access tariff filings. Each carrier that made sharing adjustments (Ameritech, Bell Atlantic, Bell South, and Nevada Bell) failed to add back amounts related to price reductions associated with sharing.

well as with the manner in which the Commission traditionally has applied its requirements governing subsequent year rate of return adjustments. On the other hand, add backs for LFAs are not provided for under the Commission's rules, and allowing such add backs as are proposed in the 1993 annual access tariff filings would not be consistent with the Commission's past application of its rate of return requirements, or with the underlying purpose of the LFA adjustment.

The Ad Hoc Committee agrees with the Commission's view, expressed in its notice of proposed rulemaking in CC Docket No. 93-179,[25/] that it was always anticipated that price cap LECs would be required to compute rates of return for the price cap sharing mechanism in essentially the same manner used by rate of return carriers in determining overearnings; and, consequently, that the Commission's existing rules require price cap carriers to add back amounts related to price adjustments associated with sharing.[26/] While the Committee further agrees that it is appropriate that the Commission, concurrently with its investigation of the 1993 annual access tariff filings and its consideration of the add back issue as it applies to relevant tariff provisions under investigation in this proceeding, take such steps as may be necessary to clarify through its CC Docket No. 93-179 rulemaking the application of its existing rate of

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25/ Price Cap Regulation for Local Exchange Carriers -- Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, FCC 93-325, released July 6, 1993 (the "NPRM").

26/ NPRM, para. 32.

return rules with respect to price cap carriers, it is important to recognize that the existing rules have not been applied to rate of return carriers to allow them to make subsequent year add back adjustments to their authorized rates of return to compensate for prior year underearnings. Instead, carriers have been permitted to remedy underearnings through rate increases. Thus, if the Commission is to achieve parallel application of the rules to price cap carriers -- its stated intention -- it must not allow LFAs.

A. LEC Procedural Objections Should Be Rejected -- The Commission Correctly Proposes To Enforce Its Existing Rate Of Return Adjustment Rules Against Price Cap LECs

Several LEC Direct Cases attempt to erect procedural hurdles which effectively would block Commission consideration of relevant prior year sharing and low-end adjustment issues in its review of the 1993 annual access tariffs. Pacific Bell argues that the Commission is precluded from investigating tariff filings raising such issues in this proceeding because the "same issue" is being addressed concurrently in the Commission's rulemaking proceeding under CC Docket No. 93-179.[27/] In a similar vein, other LECs attempt to characterize the Commission's investigation of the add back issue as "retroactive rulemaking."[28/] Such arguments are contrived and specious. Moreover, if accepted, the Commission would be left powerless to

27/ Pacific Bell Direct Case, pp. 5-8.

28/ See, e.g., Bell Atlantic Direct Case, p. 7; GTE Direct Case, p. 24.

prevent LECs from manipulating add back and low end adjustment mechanisms in their 1993 access tariffs to serve their own interests.29/

The validity of the Commission's decision to designate the prior year sharing/low-end adjustment issue in its Designation Order is in no sense compromised by the Commission's concurrent initiation of its rulemaking proceeding in CC Docket No. 93-179. Indeed, because certain LECs in fact had a sharing amount or low end adjustment based on 1991 earnings, consideration of this issue in the 1993 annual access tariff investigation in respect to such LECs is indispensable to fulfilling the Commission's responsibilities under Section 204 of the Communications Act irrespective of whether an existing rule applies. In short, to pass upon the lawfulness of the 1993 annual access tariffs filed by LECs that had a sharing amount or low-end adjustment last year, the Commission is required to consider the LECs' implementation of sharing and low-end adjustment mechanisms in the context of its investigation in this proceeding even if on an ad hoc basis. At the same time, the Commission may properly proceed as proposed in CC Docket No. 93-179 to consider adoption of a formal clarification of its rules.

29/ As noted earlier (fn. 24), the results of according the LECs such discretion are readily predictable. The only carriers employing add back in their 1993 annual access tariff filings were those that made low-end adjustments (NYNEX and SNET). The carriers that made sharing adjustments (Ameritech, Bell Atlantic, BellSouth and Nevada Bell) failed to add back amounts related to price reductions associated with sharing.

Contrary to Pacific Bell's assertions, this does not mean, nor has the Commission "announce[d]", "that it may apply retroactively in this proceeding a rule it has only proposed in a different proceeding."[30] The Commission has "announced" nothing beyond the designation of an issue for investigation. Furthermore, as expressly stated in the NPRM, the Commission has not "proposed" a new rule, but is simply clarifying that its existing rate of return "backstop" mechanisms were from the outset intended to apply to price cap as well as to rate of return carriers.

Somewhat inconsistently, Pacific Bell also asserts that the Commission should not attempt a "rule change" in the "course of adjudicating the reasonableness of individual tariffs" and contends that "to fashion major rules on the basis of particular tariffs raises obvious issues about the fairness of applying a newly announced rule retroactively and the completeness of the record on which the new rule is based."[31] However, the Commission is not proposing to "fashion major rules on the basis of particular tariffs", but to investigate the relevant tariffs in this proceeding while, at the same time, initiating a separate formal rulemaking (CC Docket No. 93-179) for the very purpose of developing a record -- independent of particular tariff filings -- upon which to fashion any rule clarification that may be required. Nor has the Commission applied a "newly announced rule

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30/ Pacific Bell Direct Case, p. 8.

31/ Id.

retroactively". Quite obviously, rules are merely proposed in an NPRM, and a related issue has been designated (not resolved) in the Designation Order. Certainly, the LECs should not be heard to complain that the Commission has initiated a separate rulemaking while in the same breath contending the rule "change"[32/] is too important to be dealt with in the context of the Commission's review of the 1993 annual access tariff filings. Such procedural gambits designed to shield the carriers' access tariffs from scrutiny and appropriate disposition by the Commission should be rejected.

The judicial precedents relied upon by Pacific Bell in an effort to cast the Commission's investigation of this issue as procedurally infirm are not persuasive. Citing AT&T v. FCC, 974 F.2d 1351 (D.C. Cir. 1992), Pacific Bell argues that if the Commission were to require the add back it would be substantively changing the price cap rules in the guise of a "clarification."[33/] While it is true that the Commission has characterized the proposed adoption of the add back requirement as a clarification of its rules, and correctly so, the characterization is a moot point since here the Commission does propose implementing its proposal through a formal notice and comment rulemaking proceeding under CC Docket No. 93-179. This clearly distinguishes the circumstances here from those in the

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32/ As discussed subsequently, the "change" is more properly characterized as a clarification.

33/ Pacific Bell Direct Case, p. 7.

case relied upon by Pacific Bell where the Commission undertook to implement a substantive change in a rule without benefit of rulemaking under the pretense of effecting a "clarification."

AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992) is similarly inapposite to the circumstances presented here. In that case the Commission dismissed a complaint filed by AT&T alleging that MCI had violated the Communications Act by charging rates not provided for under any tariff on file with the Commission. In lieu of considering the complaint, the Commission elected to address the issue in a rulemaking proceeding wherein it was considering the regulatory forbearance policies under which MCI was not required to file tariffs. The Court held that AT&T was entitled to an adjudication of its complaint and that such an adjudication could not be deferred or avoided by reliance on related rulemakings. In contrast, in its Designation Order here the Commission has determined that it will adjudicate the prior year sharing/low-end adjustment issue in its tariff investigation proceeding, even as it proceeds through rulemaking to adopt a rule of general applicability. Indeed, it is that very determination -- to adjudicate the issue in this proceeding -- that Pacific Bell argues is improper. If anything, what Pacific Bell proposes, not what the Commission has done, would be inconsistent with the Court's holding in the forbearance policy case. Therefore, consideration of the matters posed under Issue 2 in the Commission's investigation of the 1993 annual access charge tariffs is procedurally sound notwithstanding the initiation of the rulemaking proceeding under CC Docket No. 93-179.

B. The Rationale For Requiring Add Back Is Equally Applicable To Price Cap Carriers As To Rate Of Return Carriers

The Ad Hoc Committee believes that application to price cap carriers of a procedure similar to the add back used by rate of return carriers is entirely reasonable. However, certain of the LEC Direct Cases would argue that, unlike rate of return regulation, price cap regulation was intended to "harness the profit-making incentives common to all businesses" and that the "overearnings" which may be restricted under rate of return regulation are "legally sanctioned under price cap regulation."[34/] These arguments misapprehend the price cap structure adopted by the Commission and overlook relevant portions of the Commission's discussion in its NPRM. As stated in the NPRM, the Commission did not adopt a "pure" price cap plan, but opted for a plan that remains subject to rate of return type overearnings controls while at the same time allowing for productivity incentives.

> The Commission was concerned, however, that a pure price cap plan might introduce unintended results as applied to many individual LECs and their varying operational and economic circumstances. For this reason, the Commission included a rate of return-based backstop mechanism in the LEC price cap plan. The plan retains productivity incentives by allowing LECs earnings to vary within a wide range around the initial 11.25 percent rate of return. Outside that range, the

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34/ *See*, *e.g.*, Pacific Bell Direct Case, pp. 5-6.

sharing and lower end formula adjustments apply to adjust the price cap index.[35]

As is apparent from the foregoing passage, the LECs' assertions that overearnings are "legally sanctioned" under price cap regulation and that a backstop mechanism is somehow foreign to price cap regulation are unfounded. Indeed, and as noted in the NPRM, the Commission from the outset anticipated that a price cap backstop would operate in much the same way as rate of return enforcement for LECs that remained subject to rate of return regulation, and that price cap carrier rates of return would continue to be calculated and reported in essentially the same manner. Further, where the Commission found that changes in its application of rate of return mechanisms to price cap carriers were appropriate, it specifically adopted them. No alternative to the add back mechanism was included among these changes.[36]

The NPRM correctly concludes that not employing an add back mechanism could result in an "effective" rate of return which falls outside the range of returns judged by the Commission to be reasonable. Further, in the NPRM, the Commission specifically addresses the question of whether application of the add back is consistent with the productivity incentives of its price cap

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35/ NPRM, para. 7. (Footnotes omitted).

36/ In reviewing the comments filed in the price cap rulemaking proceeding, the Commission found that no one had "discussed the details of rate of return calculations, or requested that we eliminate add-back from the rate of return calculations of the LEC price cap plan." NPRM, para. 10. Based upon this history, the Commission's NPRM correctly characterizes its proposed rule change as a clarification of existing rules.